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No. 82-687

IN THE

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

v.

ARTHUR YOUNG & COMPANY
and
AMERADA HESS CORPORATION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT AMERADA HESS CORPORATION

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QUESTION PRESENTED

WHETHER, ABSENT THE MOST COMPELLING OF CIRCUMSTANCES, FUNDAMENTAL FAIRNESS DICTATES THAT THE GOVERNMENT SHOULD BE PRECLUDED FROM PROBING THE THOUGHT PROCESSES OF ITS CITIZENS OR INTRUDING UPON THOSE RELATIONSHIPS ENTERED INTO WITH A SUBSTANTIAL EXPECTATION OF PRIVACY.

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BRIEF FOR ARTHUR YOUNG & COMPANY

PRELIMINARY STATEMENT

As the Internal Revenue Service ("Service" or "IRS") has recognized in its Petition for Writ of Certiorari, this case is of major importance to the accounting and legal professions. Petition for Writ of Certiorari at 7. It is also of critical significance to the effective operation of the federal securities laws and the flow of accurate financial information to the public markets. Finally, it raises issues concerning the extent to which the Government may intrude into the thought processes of its citizens particularly when it is in an adversarial position with them.

In this case the Service seeks unfettered access to certain workpapers created by Arthur Young during its audits of the 1972, 1973, and 1974 financial statements of Amerada Hess Corporation ("Amerada"). These workpapers — Arthur Young's tax accrual file — form the basis for its opinions with respect to the accounting treatment for tax liabilities in Amerada's financial

statements for those years. Tax accrual workpapers contain analyses of the strengths and weaknesses of the client's tax positions, speculation about tax law developments, and conjecture regarding the litigation positions and possible settlement of litigation with the IRS with respect to previously filed tax returns. Contrary to the Government's claim (Pet. Br. at 10, 14-15, 24),[1] the affidavits submitted below unequivocally show that the tax accrual workpapers do *not* contain facts not otherwise available to the Service (JA 31-32 ¶¶26-29; JA 38).

The Service argues that these workpapers would shed light on the taxpayer's state of mind in preparing its returns because the taxpayer may have ignored the accountant's advice (Pet. Br. at 10, 25) — a position which its own brief actually contradicts (*id.* at 23 - tax accrual workpapers relate "to the tax treatment of transactions occuring in *prior* years"). The Service also argues that having access to these papers would make its job easier by providing a road map through the thicket of facts, theories, and tax possibilities (*id.* at 25-26) by highlighting a taxpayer's vulnerabilities (*id.* at 27). In addition, the Service argues that failure to obtain access to tax accrual workpapers might impede tax investigations. (*Id.* at 14). However, other than its *ipse dixit*, the record does not support this bald claim and, in fact, contradicts it. At best, the IRS claim of "need" amounts to no more than the well worn claim of "administrative convenience." The Service now concedes, for the first time and contrary to its prior pronouncements, that its real intent is to discover the thought processes and mental impressions of the taxpayer and the taxpayer's auditor. (Pet. Br. at 10, 26, 27.)

The real focal point of this case is whether the Government has the right to probe both (i) the thought processes of the independent auditor with respect to the reasonableness of the client's provision for tax liabilities in its financial statements and (ii), to the extent they are reflected in the tax accrual work papers, the thought processes of the taxpayer. This latter inquiry, however, is not directed at the preparation of the tax return, a matter as to

1. The following abbreviations are used in this brief: IRS Brief on the Merits ("Pet. Br. at ") and Joint Appendix ("JA").

which the affidavits below show that tax accrual papers are unrelated (JA 32 ¶29), but at the taxpayer's views on *pending* disputes with the Service. Allowing the Service access to these thought processes is no different from allowing an adversary access to an attorney's mental impressions and strategies in the course of litigation—a concept which is alien to the notion of fair play in our judicial system.

There are several critical policy issues at stake in this case including:

(1) balancing the respective needs of the IRS and the investing public,

(2) the appropriateness of a "work product" doctrine for accountants under certain limited circumstances, and

(3) the showing of relevance required of the IRS in a summons enforcement proceeding.

The resolution of each of these issues must be guided by one overriding consideration — fundamental fairness.

In the name of administrative convenience, the IRS seeks the Court's imprimatur on a policy the very effect of which runs counter to the concept of fundamental fairness. Just as this Court sanctioned the creation of the attorney work product doctrine 36 years ago because of concerns of fundamental fairness, so too considerations of fundamental fairness dictate that the protection afforded tax accrual workpapers by the Second Circuit be sanctioned.

As with any subject of such significance, the question of IRS access to tax accrual workpapers has generated substantial commentary. With the exception of one article written by a government attorney,[2] every commentator who has treated the issue agrees that the IRS should be denied access to those papers.[3]

2. Nath, *Internal Revenue Service Summonses for "Sensitive" Accountants' Papers*, 34 VAND. L. REV. 1561 (1981).

3. Buchholz, *Tax Accrual File Controversy Legal Problems Facing the Accountant*, 40 INST. ON FED. TAX'N 37-1 (1982); Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194 (Oct. 1979); Caplin, *Government*

STATEMENT OF THE CASE

A. The IRS Audit of Amerada's Tax Returns

In 1975 the Service commenced an audit of Amerada's 1972, 1973, and 1974 tax returns. The audit was routine; the Service has audited all Amerada tax returns for many years under what is now called the Coordinated Examination Program ("CEP"). 2 [Audit] INT. REV. MAN. (CCH) § 42(11) *et seq.*

For those large, multinational corporations which are designated for CEP status, the Service has its own office space within the taxpayer's offices, deals on an almost daily basis with corporate personnel and records, and reviews tens of thousands of documents. As a result of a CEP audit, the agents assigned to a taxpayer's audit become quite knowledgeable about the corporate taxpayer, its structure and organization, and its operations.

Access to Independent Accountants' Tax Accrual Workpapers, 1 VA. TAX REV. 57 (1981); Carter, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604 (1982); Diss and Hanson, *Tax Contingency Audit Workpapers: 1981-1982 Developments, Observations and Proposals*, 14 TAX ADVIDER 154 (1983); Diss, *Background Paper of the Tax Executives Institute on the Confidentiality of Tax Accrual Workpapers*, 27 T.E.I. NEWS 1 (1981); Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66 (1982); Stoltenberg and Robinson, *Enforcement of Summonses in Requesting Accountants' Workpapers*, 60 TAXES 673 (1982); Valdivia, *Comment-United States v. El Paso Co.: A Shift in Policy Towards IRS Summons of Tax Accrual Workpapers*, 36 TAX LAWYER 835 (1982); Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468 (1982); Note, *Auditor-Client Work-Product Privilege With Respect to Tax Accrual File: The Arthur Young Case*, 27 ST. LOUIS U.L.J. 437 (1983); Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185 (1982); Comment, *The Creation of an Accountant Workproduct Privilege - Rendering Relevancy Irrelevant: United States v. Arthur Young & Co.*, 57 ST. JOHN'S L. REV. 348 (1983). *See also* Report by Justice Department Advisory Committee on Tax Litigation, on Standards for Seeking Accountants' Tax Accrual Workpapers, *Daily Report for Executives (BNA)*, DTA No. 100, at J-10, 11 (May 21, 1980)

But cf. Jacobson & Steel, *The Auditor Work-Product Privilege, The Fifth Circuit Spurns the Second Circuit's Creation of a Novel Privilege*, 16 THE REVIEW OF SECURITIES REGULATION NO. 10 at 13, (May 18, 1983) (critical of legal reasoning, but recognizing legitimate concerns by auditors).

In the audit at issue here the Service made 400 civil document requests to Amerada (JA 86), 398 of which Amerada complied with (*id.*),[4] providing access to "45,000 pages of documents underlying these tax returns" to the Service (JA 65 ¶ 10). The civil document requests ranged from the broad (*e.g.*, JA 70) to the specific (*e.g.*, JA 68-9, 71-2) and covered the gamut of Amerada's operations (JA 64). In addition to document requests, the Service took 36 sworn statements. (JA 96).

Amerada alone expended some 11,500 hours or 6 person years responding to requests by the Service on the audits at issue. (JA 64). By the time the Service sought documents from AY, it had extensive amounts of information in its possession. In fact, it had substantially completed its audit because it had already issued the "proposed civil tax adjustments to Amerada." (JA 103).

B. AY and the Audit Function.

As a public company, Amerada is required to file audited financial statements with the Securities and Exchange Commission. Those audited financial statements are a critical source of information for the investing public in deciding whether to buy or sell Amerada securities. Since 1971, AY has audited the annual financial statements of Amerada. The purpose of an audit is to permit the independent auditor to render an opinion on whether the financial statements have been prepared in accordance with Generally Accepted Accounting Principles ("GAAP") on a basis consistent with prior years. *SEC* v. *Arthur Young & Co.*, 590 F.2d 785, 788 n.2 (9th Cir. 1979). The audit does not determine whether an individual account is correct, but whether the financial statements *taken as a whole* are fairly presented in accordance with GAAP. AICPA, PROFESSIONAL STANDARDS, STATEMENTS ON AUDITING STANDARDS NO. 1.

4. Amerada's unwillingness to comply with the two requests was based on the fact that the materials sought were subject to work product and privilege protection.

In connection with any audit, AY prepares workpapers to reflect the judgments it makes with respect to the financial statements. Audit workpapers are prepared to (i) document compliance with Generally Accepted Auditing Standards ("GAAS"), (ii) facilitate supervision and review of the work, and (iii) provide a record of the work. The workpapers contain a myriad of materials most of which, however, have absolutely no conceivable relevance to a corporation's tax return, let alone its correctness because, as this Court has repeatedly noted, *see, e.g., Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), financial accounting and tax accounting are not the same.[5]

The "numbers" in a financial statement are largely the result of complex judgments which management and auditors make about the probable outcome of future events. Philip A. Loomis, Commissioner, Securities & Exchange Commission, Speech, *Current S.E.C. Projects in Accounting and Financial Reporting*, before a Seminar of the Machinery and Allied Products Institute, June 24, 1974, at 5 ("[T]he figures in large part reflect judgments and accounting conventions."). For example, reserves for uncollectible receivables and allocations of cost pools between various entities are estimates for which there are no hard and fast guidelines. (JA 27 ¶ 15-16).

One area of financial accounting requiring the most difficult and sensitive of judgments by the auditor is the tax accrual review, which represents judgments and opinions concerning the existence and timing of the client's tax liability. In that review the auditor considers whether the amount stated in the tax liability account in the financial statements is "materially" correct. (JA 28-32). The tax liability account in the financial statements, which is not the same as the tax liability shown on the tax return, includes, *inter alia*, (i) *estimated* taxes currently due, (ii) *estimated* taxes due in the future (*e.g.*, such as deferred taxes), and

5. *See* Cross-Petition for Writ of Certiorari of Arthur Young & Company, No. 82-837, filed November 19, 1982, pending. (Because financial accounting and tax accounting have "vastly different objectives," 439 U.S. at 542, there is no presumptive relevancy between audit workpapers dealing with financial accounting matters and "ascertaining the correctness" of a tax return.)

(iii) possible provisions for amounts due for disallowances of prior year returns and contested items in the tax court. It is net of refunds due a taxpayer because of the availability of a net operating loss or because of claims for refund which may be currently in litigation with the Service.

The tax accrual analysis is prepared in connection with the annual audit of a corporation's financial statements (ACCOUNTING RESEARCH BULLETIN No. 50) and, as to public companies, is part of the independent auditor's performance of his statutory duties under the Securities laws (*see, e.g.*, REGULATION S-X, Rule 4.08(g), 17 C.F.R. § 210.4-08(g)).

The tax accrual review includes, *inter alia*, the auditor's judgments on:

- whether the IRS is likely to issue a deficiency letter and the likely disposition of that deficiency;
- whether a client will litigate or compromise a disputed tax treatment, and if it intends to compromise, in what amount;
- whether a change in the case law or Service's position occurred after the client's tax return was filed and its effect, if any, on that return;
- whether the IRS might interpret the law or regulations applicable to a transaction in a different manner than does the taxpayer or the courts and the impact of such a treatment;
- whether there exist differences of judgment with respect to the effect of transactions in question; and
- whether a taxpayer's claim for refund is likely to result in a settlement or recovery after litigation.

The Service has characterized from its perspective that portion of the audit process relating to tax accruals:

> Part of the auditing function is to evaluate the sufficiency of the client's reserves to meet its potential tax liability. This evaluation is based in part on the accountant's analysis of corporate records and in part on *its assessment of opinions and projections communicated in confidence by the client*. In reaching its conclusion the accountant considers all uncertain tax positions taken by

> the client and determines the extent of reserves necessary to cover the liability that would result assuming that all such questions were resolved against the client.

1 [Audit] INT. REV. MAN. (CCH) § 4233, ch. 232.8(4), at 7281-22 (emphasis added).

In performing a tax accrual review an auditor needs a thorough understanding of the tax laws, as well as of the company's books and records. Also, the auditor must obtain information through candid discussions with client personnel *as well as* the client's counsel (inside and outside) who may be handling a tax dispute (*e.g.*, in tax court) or advising the client with respect to tax issues. This is an essential part of the audit process. Without frank, open, and candid discussions to obtain the client's views on (i) the underlying transactions, (ii) the issues the company itself believes are, or could be, sensitive in a challenge by the Service, and (iii) management's likely action (*e.g.*, the likelihood of settlement and the amount thereof), completion of an audit in accordance with GAAS might be impossible. *See* AICPA, PROFESSIONAL STANDARDS A.U. § 9326.06, *Evidential Matter: Auditing Interpretations of AU Section 326*, (failure to obtain adequate evidential support for the tax accrual can lead to a scope qualification in the audit). Thus, if the auditor's ability to communicate freely and candidly with management were impaired, the potential for materially misleading financial statements and/or a possible scope qualification in the auditor's report on the financial statements, which is unacceptable to the SEC, would be materially increased.

Significantly, as the affidavits below show, tax accrual workpapers are not used in connection with the preparation of the tax returns and they do not and cannot serve to prove or disprove the "correctness" of a taxpayer's tax return. (JA 28 ¶ 18; JA 32 ¶ 29). In fact, much of the tax accrual review relates to tax returns already filed and tax positions previously taken by the taxpayer and may focus on the possible outcome of *pending* audits and litigation between the Service and taxpayer, all of which are only with respect to returns previously filed. Thus, the Service's position that the tax accrual workpapers will reflect on

the taxpayer's state of mind in preparing the return is specious to the extent that the workpapers are created by the auditors *after* the returns have been prepared (*see, e.g.*, Pet. Br. at 25); and is in fact contradicted by Service's own brief (Pet. Br. at 23 — the tax accrual account "reflects the sum of contingent tax liabilities relating to the tax treatment of transactions occurring in *prior years* that may give rise to possible, but not agreed to, adjustments in the corporation's tax liabilities for those years." (emphasis added).

Thus, the tax accrual papers reflect the opinions and judgments of the auditors about the taxpayer's positions and possible adversary positions of the Service.[6] Were the information in the tax accrual file to be made available to the Service, a company's ability to defend its position or to strike a reasonable settlement would be seriously impaired.[7] The Service would have a

6. Although some of these judgments may be made without regard to the underlying facts, the auditor needs to understand the transactions at issue. To the extent these judgments are based on factual data, the affidavits below unequivocally show that such factual data is otherwise available in the taxpayer's records, elsewhere in the workpapers, or in publicly available documents. (JA 32 ¶ 29, JA 38 ¶ 3)

7. An example of this process involving oil companies is the "Delineation Wells Issue." (Delineation Wells are used to determine the location of an offshore oil and gas reservoir.) The Service has uniformly disallowed Delineation Well costs. In a test case before the Tax Court, *In re Standard Oil Co. (Indiana)*, 68 T.C. 325 (1977) ("the *Amoco* case"), *aff'd sub nom., Sun & Co. & Subsidiaries (Consol.)* v. *Commissioner*, 677 F.2d 294 (3d Cir. 1982), the oil companies prevailed and the appeal was dismissed. The Service has brought and lost at least two other cases on the same issue. Notwithstanding the dismissal of the appeal, the Service continued to disallow Delineation Well expenses on audit. However, as a result of a change in the tax law, the issue is no longer "is it deductible at all", but only "when" is it deductible.

Management had to decide how the company's tax liability is affected by *Amoco*, as well as the Service's continued challenge notwithstanding the Tax Court decision. Similarly management had to decide whether to accrue an amount for the potential tax liability and, if so, how much. Next the auditor had to review that accrual to see if management's evaluation is reasonable, and if not, whether the differences are material. Even if the auditor were to disagree with management's assessment of its tax position, this disagreement would not impact the tax returns in any way but would only affect the audit opinion on the taxpayer's financial statements if the disagreement related to a material amount.

The tax accrual workpapers will reflect the auditor's thought process and management's views as to whether it will stand and fight or, if it

"roadmap" of the issues which the taxpayer believes are sensitive and of the taxpayer's assessment of the strengths and weaknesses of its positions on, and settlement prospects with respect to, those issues. The taxpayer, confronted with being challenged on every point, would be forced to compromise otherwise valid positions because of the risk and expense of litigation, or else engage in protracted litigation to vindicate its rights. *United States* v. *Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1981), *cert. granted*, U.S. , 103 S.Ct. 1180 (1983).

To permit one side to have that sort of "inside" information concerning the settlement posture and litigation strategies creates unequal bargaining power. Thus, the availability of such information from the auditor in a neat, compact form for the Service to pluck at its choosing creates undue tension between the audited entity and its auditor. Indeed, this tension has caused clients to be more guarded in their discussions with their auditors, and it has caused counsel representing taxpayers in litigation with the Service to be less willing to discuss the proceedings. This is not idle speculation, but a reality which Arthur Young and other major accounting firms have experienced in their practice. In fact, IRS Commissioner Roscoe Egger has conceded this. Internal Revenue News Release, IR-81-49, *reprinted in Daily Report for Executives (BNA)*, DTR NO. 86, at J-1 (May 5, 1981) (access to the auditor's tax accrual workpapers has "real potential for serious negative effects on the quality of financial reporting.")

SUMMARY OF ARGUMENT

This Court recently reaffirmed its longstanding commitment to limiting Government investigations and discovery "for sound reasons—ranging from *fundamental fairness* to concern about burdensomeness and intrusiveness." *United States v. Sells Engineering, Inc.*, U.S. , 103 S. Ct. 3133, 3143 (June 30, 1983) (emphasis added). By seeking access to

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chooses to compromise, in what amount. Obviously, if the Service knows management's position, it gives the Service a superior bargaining position on issues it has *thrice lost* in court. The inherent unfairness of this is self-evident.

tax accrual workpapers containing the thought processes of the taxpayer, its auditors, and its counsel, and thus creating an unfair advantage in an adversary process, the Government affronts the concept of fundamental fairness. The "administrative convenience" of the Service cannot justify such a result.

Courts and legislative bodies insure that litigation is fairly conducted by protecting or insulating certain types of information from disclosure through, *inter alia*:

- the balancing of competing and legitimate societal interests when they are in conflict;
- the creation of privileges or doctrines limiting access to information; and
- standards of relevancy and materiality.

The Second Circuit combined the first two of these approaches. It found that protecting tax accrual workpapers from disclosure would serve the interests of the investing public without weakening the enforcement of the revenue laws, and it effected that protection by creating a limited and qualified work product doctrine for auditors. With respect to the third of these approaches, however, the Second Circuit held, we believe incorrectly and contrary to both the facts in this case and the law, that the tax accrual workpapers are relevant.

Arthur Young respectfully submits that each of the foregoing bases provides a separate, independent ground for this Court to affirm the decision of the Second Circuit.

ARGUMENT

ACCESS TO AN AUDITOR'S TAX ACCRUAL FILES BY THE INTERNAL REVENUE SERVICE, ABSENT THE MOST COMPELLING OF CIRCUMSTANCES, RUNS COUNTER TO PRINCIPLES OF FUNDAMENTAL FAIRNESS AND WILL ERODE IMPORTANT PROFESSIONAL RELATIONSHIPS WHOSE PRESERVATION IS CRITICALLY IMPORTANT

Critical to the Second Circuit's opinion denying IRS access to the tax accrual workpapers was the concern that such access, absent the most compelling need, would run counter to the very concept of fundamental fairness and put the taxpayer at an unfair disadvantage in dealing with the Service. As that court noted:

> We do not agree with the dissent's statement that in the end, the corporation "pay[s] only what the tax laws required it to pay in the first place." This would be true if every difference of opinion were litigated. But the fact is that very few controversies reach that stage. In reality, at the end of an audit, the IRS and the taxpayers frequently compromise out their differences, each giving a little. Such negotiations strike an appropriate balance between collecting revenue and conserving judicial resources, but requiring the taxpayer alone to disclose settlement positions would improperly weight the balance.
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> • • •
>
> Divulging this information necessarily puts the taxpayer-corporation at a substantial disadvantage when it is audited. The prejudice involved in exposing to the Service appraisal of a taxpayer's weaknesses and settlement positions on audit is of such proportions that a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602.

677 F.2d at 220 (footnote omitted).

The court recognized that the burden imposed on the taxpayer was so great that, were it to allow such access to the IRS under these facts, other societal interests would be threatened.

On numerous occasions this Court has focused on considerations of fundamental fairness as it weighed competing interests to determine whether disclosure would be ordered. Most recently, in *United States* v. *Sells Engineering, Inc.*, U.S. , 103 S. Ct. 3133, 3143 (June 30, 1983), this Court recognized that "limitations imposed on investigation and discovery exist for sound reasons — ranging from fundamental fairness to concern about burdensomeness and intrusiveness." *See also United States v. Baggot*, U.S. , 103 S. Ct. 3164, 3167 n.4 (June 30, 1983) ("particularized need test is a criterion of *degree*"; it requires that the materials sought be "'needed to avoid a possible injustice in another judicial proceeding'.") (emphasis in original). In the context of access to grand jury testimony, this reflected "a judgment that not every beneficial purpose, or even every valid governmental purpose, is an appropriate reason for breaching grand jury secrecy." *Id.* at 3167. Similarly, this Court has held that "it is rarely justifiable for the [government] to have exclusive access to a storehouse of relevant fact." *Dennis v. United States*, 384 U.S. 855, 873 (1966) (footnote omitted).

This Court has repeatedly rejected protestations of administrative convenience, savings of time and expense, or other "shortcuts" if their effect results in inequity in the litigation process or unduly prejudices other societal interests. Thus, in *Sells* this Court noted that the "civil lawyer's need is ordinarily nothing more than a matter of saving time and expense. The same argument could be made for access on behalf of any lawyer in another government agency, or indeed, in private practice. We have consistently rejected the argument that such savings can justify a breach of grand jury secrecy." 103 S. Ct. at 3142.

This concern for fundamental fairness is the touchstone of numerous other decisions involving the relationship of the government and its citizens. *See, e.g., Federal Open Market Committee*

v. *Merrill*, 443 U.S. 340, 359-60 (1979) (unfair to place party at a competitive disadvantage in contract negotiations); *Marshall* v. *Barlow's, Inc.*, 436 U.S. 307, 322 (1978) ("Nor do we agree that the incremental protections afforded the employer's privacy by a warrant are so marginal that they fail to justify the administrative burdens that may be entailed."); *Schneider* v. *Rusk*, 377 U.S. 163, 167 (1964) (administrative convenience will not justify violation of due process); *Commissioner* v. *Lester*, 366 U.S. 299, 306 (1961) (Douglas, J., concurring) ("The revenue laws have become so complicated and intricate that I think the Government in moving against the citizen should also turn square corners."); *United States* v. *Bryan*, 339 U.S. 323, 331 (1950) (exemption from discovery where substantial individual interest outweighs public interest in search for truth); *International Shoe Co.* v. *Washington*, 326 U.S. 310, 316 (1945) (sufficient minimum contacts with forum so that "maintenance of the suit does not offend 'traditional notions of fair play and substantial justice'."); *Bowsher* v. *Merck & Co.*, U.S. , 103 S. Ct. 1587, 1594, 1599 (April 19, 1983) ("must balance the public interest served by full GAO investigations against the private interest in freedom from officious governmental intermeddling in the contractor's private business affairs"). *See also Stevens* v. *Marks*, 383 U.S. 234, 247 (1966) (Harlan, J., concurring in part and dissenting in part) (In exacting waiver of the privilege of immunity the state should turn square corners.); *United States* v. *Seckinger*, 397 U.S. 203, 221-22 (1970) (Stewart, J., dissenting).[8]

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8. An analog also exists in this Court's Fourth Amendment decisions:

> The essential purpose of the proscriptions in the Fourth Amendment is to impose a standard of "'reasonableness" upon the exercise of discretion by government officials . . . in order "to safeguard the privacy and security of individuals against arbitrary invasions . . . ." *Marshall* v. *Barlow's, Inc.*, 436 U.S. 307, 312 (1978), quoting *Camara* v. *Municipal Court*, 387 U.S. 523, 528 (1967). Thus, the permissibility of a particular law enforcement practice is judged by balancing its intrusion on the individual's Fourth Amendment interests against its promotion of legitimate governmental interests. Implemented in this manner, the reasonableness standard usually requires, at a minimum, that

Most recently this Court denied access under the F.O.I.A. to work product materials even though the litigation was long since terminated. Although the decision is written in the language of statutory construction, it is equally clear that a critical concern was the very same concept of fundamental fairness which led to the creation of the work product doctrine in the first instance. *F.T.C.* v. *Grolier Inc.*, _____ U.S. _____, 103 S. Ct. 2209, 2216 (June 6, 1983) (Brennan, J., concurring in part).

Thus the concept of "fundamental fairness" has its roots in many different judicial and statutory policy considerations. Articulation of the fundamental fairness concept within traditional legal theories can be found in creating privileges from discovery, defining relevancy and materiality, and the balancing of competing legitimate interests — each of which provides the basis for affirming the decision of the Second Circuit.

Allowing IRS access to the independent auditor's tax accrual workpapers would destroy the balance between government and taxpayer in an adversarial setting without promoting any countervailing interest.[9] Moreover, it would prejudice the important

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the facts upon which an intrusion is based be capable of measurement against "an objective standard," whether this be probable cause or a less stringent test. In those situations in which the balance of interests precludes insistence upon "some quantum of individualized suspicion," other safeguards are generally relied upon to assure that the individual's reasonable expectation of privacy is not "subject to the discretion of the official in the field" [citations omitted].

Delaware v. *Prouse*, 440 U.S. 648, 653-55 (1979) (footnotes omitted).

9. Arthur Young recognizes, as did the Second Circuit, 677 F.2d at 221, that there may be instances where a sufficient showing of need can be made to justify access to the tax accrual file. As here, where the tax accrual files contain primarily opinions and any factual data in them is otherwise available, no such showing has or can be made.

The Service's claim that the decision below threatens to impede its investigations (Pet. Br. at 14) is totally unsupported by the record, which, in fact, demonstrates the contrary. The Service repeatedly protests that its principal interest is to discover the relevant facts (*id.* at 27) to enable it to make its own appraisals (*id.* at 10). Yet the record demonstrates that the Service has all the relevant facts and that there is no "fact" in the tax accrual workpapers which is not otherwise available. (JA 38). What it really seeks is not the "raw" data, but to have that data

professional relationships between the auditor and its client. It is for this reason that AY has opposed enforcement of this summons and considers the issue of great importance.[10]

I.

SUBSTANTIAL COMPETING POLICY INTERESTS REQUIRE THE DENIAL OF IRS ACCESS TO TAX ACCRUAL WORKPAPERS ABSENT EXTRAORDINARY AND COMPELLING CIRCUMSTANCES

This Court has repeatedly recognized that Congress has not given the IRS *carte blanche* to summon anything it wants. Its power is circumscribed by statute with the burden of proof falling on the Service to show that it is entitled to summons enforcement.

"organized" for it so it has the taxpayer's and accountant's judgments "about which facts are *relevant* to the . . . tax liability." (Pet. Br. at 25-26).

10. Although Amerada's objection pursuant to 25 U.S.C. § 7609 precluded Arthur Young from compliance with the summons absent a court order, such an objection does not require the third-party recordkeeper to appear and oppose enforcement of the summons. Section 7609 merely provides a procedural mechanism for the taxpayer to intervene to protect its interests.

The district court found that Arthur Young refused to comply with the summons as a matter of its own independent judgment, and not because Amerada exercised its rights under § 7609. *United States* v. *Arthur Young & Co.*, 496 F. Supp. 1152, 1154 (S.D.N.Y. 1980), *aff'd in part and rev'd in part*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, _____ U.S. _____, 103 S.Ct. 1180 (1983). Arthur Young refused to comply with the summons because it contravened policies that Congress has clearly articulated, it was counterproductive, and it would have long term adverse consequences for the public. (JA 23 ¶ 5-6).

The seriousness and importance with which Arthur Young views this issue is underscored by the fact that William A. Grant, then the managing partner of Arthur Young's Tulsa office, was held in contempt of court and spent time in jail for refusing to produce Arthur Young's tax accrual workpapers on Phillips Petroleum to a grand jury in order to test the legality of the court's order requiring their production. *Arthur Young Faces Test on Protecting Client Audit Secrets*, Wall St. J., October 14, 1975, at 23. The matter was resolved with entry of a protective order *prohibiting* IRS access to the tax accrual file while granting access to that file to the grand jury. *Arthur Young & Company Gives Grand Jury Data on Phillips Petroleum*, Wall St. J., October 15, 1975 at 28. The same result is now dictated by *United States* v. *Sells Engineering, Inc.*, _____ U.S. _____, 103 S. Ct. 3133 (June 30, 1983).

United States v. *LaSalle National Bank*, 437 U.S. 298 (1978); *United States* v. *Powell*, 379 U.S. 48 (1964). Although *Powell* established a four-part test as a predicate to enforcement of an IRS summons, that test is a statement of general principle and is not exhaustive of the criteria that should be considered in enforcing a summons. *See Upjohn Co.* v. *United States*, 449 U.S. 383 (1981); *United States* v. *Bisceglia*, 420 U.S. 141, 146 (1975); *Reisman* v. *Caplin*, 375 U.S. 440, 449 (1964); *United States* v. *Humble Oil & Refining Co.*, 488 F.2d 953, 959 (5th Cir. 1974), *vacated for further consideration*, 421 U.S. 943, *aff'd per curiam on remand*, 518 F.2d 747 (5th Cir. 1975). In *United States* v. *First National Bank*, 699 F.2d 341 (7th Cir. 1983), the court refused to enforce a summons to a bank because compliance with the summons would have put bank employees at risk under the criminal statutes of a foreign country. The court noted that "what is required is a sensitive balancing of the competing interests at stake." *Id.* at 345. In so doing, it held:

> We think it significant in weighing the hardship factor that the bank employees who would be exposed to penalty and First Chicago, which would be ordering its Greek employees to act unlawfully, *are involved only as neutral sources of information* and not as taxpayers or adverse parties n litigation.

Id. at 346 (emphasis added).

Thus, in determining whether to enforce a summons, the effect of enforcement on countervailing policies enumerated by Congress must be considered. *United States* v. *Euge*, 444 U.S. 707 (1980).[11]

Among the "substantial countervailing policies" that exist in the instant case is the presence of public reporting on the financial statements of companies whose securities are widely traded. Beginning with the Securities Act of 1933, Congress created a system of disclosure for corporations having publicly traded

11. Accordingly, to the extent that the Service argues that § 7602 "*unequivocally* authorizes agents" of the IRS "to summon and inspect records that may be relevant to their investigation" (Pet. Br. at 12), this Court has already rejected such unfettered access.

securities. 15 U.S.C. §§ 77a *et seq*. One of the linchpins of that system is audited financial statements. *See, e.g.*, 15 U.S.C. §§ 77g, 77j, 78m. By these statutes, Congress determined to afford safeguards to investors by requiring that companies whose stock is sold to and by the public provide audited financial statements based on full and frank disclosure. If enforcement of an IRS summons will cause conflict with or undercut the policies embodied in other federal statutes, then the needs of both statutes must be reconciled.

The Service advances two arguments why this Court should ignore the countervailing policy considerations. *First*, according to the Service it is not for this Court, but rather for Congress, to decide which of the policies shall be enforced.[12] Careful analysis of this position, however, reveals that what the Service in fact argues is not that it is for Congress to make the decision between these conflicting policies, but rather that this Court should make the decision on behalf of the revenue laws and not the securities laws.[13] Whichever way this Court decides this issue, it is in fact making a policy decision between the two conflicting interests.

Second, the Service argues that there is no evidence in the record (a) that any conflict exists between the securities laws and the revenue code or (b) that IRS access to tax accrual workpapers creates problems in the relationship of the independent auditor and its client. To the contrary, the only evidence in the record below, which was based on firsthand experience, demonstrates the opposite to be the case. (JA 32 ¶ 27). Importantly,

12. In any event, Congress, in enacting the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, following the decision of the Second Circuit in this case, chose not to override the decision denying IRS access to Arthur Young's tax accrual workpapers. In fact, the legislative history of TEFRA supports the contrary conclusion: "[T]he Committee intends that the Secretary shall in no event require disclosure of accountant's workpapers." S. REP. NO. 97-494, 97th CONG., 2d SESS. 273, 274 (1982), *reprinted in* 1982 U. S. CODE CONG & AD. NEWS 781,1021.

13. It is ironic for the Government to denigrate the importance of the securities laws as it has done in its brief. (*See, e.g.*, Pet. Br. at 42-43- "[S]ecurities regulations relate *to nothing more than* the duty of listed corporations to file annual audited statements, and the duty of auditors to examine the statements . . ." (emphasis added)).

IRS commissioner Roscoe L. Egger publicly conceded that IRS access to tax accrual workpapers had in fact created real potential for "serious negative effects on the quality of financial reporting." Internal Revenue News Release, IR-81-49, *reprinted in Daily Report For Executives (BNA)*, DTR No. 86, at J-1 (May 5, 1981). Moreover, the public record demonstrates that there has been a substantial impairment of the independent audit process. *See, e.g.*, Rout, *Auditors Say IRS Demand For Documents is Poisoning Relations with Client Firms*, Wall St. J., January 15, 1981, at 25, cols. 4-6.

If this Court allows access to tax accrual workpapers as the Service has requested, its victory will be pyrrhic. There is little doubt that several things will flow from such unfettered access. *First*, management will substantially curtail the flow of information generated in the audit process. *Second*, counsel, who already are reluctant to communicate with auditors for fear of opening their communications to discovery, will become even more reticent. *Third*, to the extent the auditor does get information from these sources or ferrets it out without the aid of management and its counsel, the auditors may be reluctant to document fully these thought processes for fear of discovery.[14] Fishman, *Intentional*

14. The non-discovery of materials relating to the deliberative process has significant societal implications. Congress has recognized the importance of insulating the decisional process from discovery when it balanced the need to know with the need to protect the deliberative process in the Freedom Of Information Act, 5 U.S.C. § 552 (1976). The courts have reached this result in cases dealing with the thought processes of government officials and, although these cases implement a specific statutory policy, their reasoning and policy considerations are equally applicable to the instant case. *See, e.g., ISI Corp. v. United States*, 503 F.2d 558, 559 (9th Cir. 1974) (per curiam) ("The opinions, conclusions and reasonings of government officials are not subject to discovery.").

> Exemption 5 to the Freedom of Information Act:
> incorporates the governmental privilege, developed in discovery cases, to protect documents containing advisory opinions and recommendations or reflecting deliberations comprising the process by which government policy is formulated.
>
> Congress adopted exemption five in recognition of the merits of arguments from the executive branch that the quality of administrative decision-making would be seriously undermined if agencies were forced to "operate in a fishbowl" because the full

Destruction of Tax Workpapers: An Analysis of a Relatively Uncharted Area, 58 J. TAX'N 214 (Apr. 1983). Although we concur with the dissent in the Second Circuit that corporate America will not knowingly violate the federal securities laws, we nevertheless believe that the risk of error will be materially increased by allowing IRS access to the auditor's workpapers for the foregoing reasons. The "bottom line" is that the audit itself will suffer and the Service will have failed to uncover the thought processes it now seeks.

In light of the countervailing policy considerations in this case, this Court can and should place limitations on the scope of demands for discovery (whether they be under IRS summons or otherwise) to effect the appropriate balance between the needs of the IRS and those of auditors, their client, and the investing public. On this ground alone, the Service should be denied access to the tax accrual workpapers.

II.

AN AUDITOR'S WORK PRODUCT DOCTRINE FOR TAX ACCRUAL WORKPAPERS WAS PROPERLY CREATED BY THE SECOND CIRCUIT

Whether it be called a privilege or a "work product" doctrine, the method by which the Court of Appeals protected the tax accrual workpapers in this case from scrutiny by the IRS was clearly an appropriate exercise of judicial power. Courts have

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> and frank exchange of ideas on legal or policy matters would be impossible. A decision that certain information falls within exemption five should therefore rest fundamentally on the conclusion that, unless protected from public disclosure, information of that type would not flow freely within the agency.

Mead Data Central, Inc. v. United States, 566 F.2d 242, 256 (D.C. Cir. 1977) (footnotes omitted).

This Court approved the "factual-deliberative" distinction in the legislative history of Exemption 5 in *EPA v. Mink*, 410 U.S. 73, 89, 91 (1973). *See also N.L.R.B. v. Robbins Tire & Rubber Co.*, 437 U.S. 214, 241 (1978) ("The possibility that a FOIA-induced change in the Board's prehearing discovery rules will have a chilling effect on the Board's sources cannot be ignored."); *N.L.R.B. v. Sears, Roebuck & Co.*, 421 U.S. 132 (1975).

historically created privileges or doctrines to meet the exigencies of a situation and to insure that fundamental fairness is protected by the judiciary. There is historical precedent for the result reached by the Second Circuit. *See, e.g., Hickman v. Taylor*, 153 F.2d 212 (3d Cir. 1945), *aff'd*, 329 U.S. 495 (1947).

With the adoption of the Federal Rules of Evidence in 1974, any question regarding the ability of a court to create a privilege/doctrine in the circumstances here was laid to rest. Rule 501 of the Federal Rules of Evidence provides that "the privilege of a witness . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." The Senate Committee on the Judiciary, which steered the Federal Rules through Congress, stated that "a federally developed common law based on modern reason and experience shall apply." Notes of the Committee on the Judiciary, S. REP. NO. 93-1277, 93d CONG., 2d SESS. 11 (1974), *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 7051, 7058. As this Court noted in *Trammel v. United States*, 445 U.S. 40, 47 (1980): "Congress manifested an affirmative intention not to freeze the law of privilege. Its purpose rather was to 'provide the courts with the flexibility to develop rules of privilege on a case-by-case basis,' 120 CONG. REC. 40891 (1974) (statement of Rep. Hungate), and to leave the door open to change." *Accord Upjohn Co. v. United States*, 449 U.S. 383, 396 (1981).

In fact, the "Federal Rules of Evidence acknowledge the authority of the federal courts to continue the evolutionary development of testimonial privileges in federal criminal trials 'governed by the principles of the common law as they may be interpreted . . . in the light of reason and experience'." *Trammel v. United States*, 445 U.S. 40, 47 (1980) (*quoting* FED. R. EVID. 501). Congressional enactment of Rule 501 thus "provide[s] the courts with greater flexibility in developing rules of privilege on a case-by-case basis." *United States v. Gillock*, 445 U.S. 360, 367 (1980).

Thus, courts have fashioned privileges from discovery where appropriate, and this willingness to shape the law of privilege to

meet developing needs even extends to the most sacrosanct forum for discovery, the grand jury. In *In re Subpoena Served upon Jorge S. Zuniga, M.D.*, _____ F.2d. _____, Nos. 82-1906, 82-1907, 82-1964 (6th Cir. August 3, 1983), the court held that in appropriate circumstances a patient-psychiatrist privilege will preclude enforcement of a grand jury subpoena. Similarly, a new qualified "academic freedom privilege" protecting the names of and identities of academicians participating in tenure evaluations from an EEOC investigation was created in *E.E.O.C. v. University of Notre Dame DuLac*, No. 82(c) 104 (7th Cir. August 17, 1983). Thus, the courts have been willing to create new "privileges" under Rule 501 even when there is an adverse government interest.

Here, applying the teachings of both Rule 501 and this court's admonition in *Trammel*, the Second Circuit continued "the evolutionary development of testimonial privilege . . . in the light of reason and experience." 445 U.S. at 48.It weighed the various competing factors and determined that the tax accrual workpapers, under the facts here present, should be insulated from unfettered IRS access. It carefully crafted the protection so that there could be access on "a sufficient showing of need." 677 F.2d at 221. Thus, to the extent that the Service avers that there is no basis for creation of the privilege, its arguments run contrary to well-established law.

Couch v. United States, 409 U.S. 322 (1973), which the Service frequently cites (Pet. Br. at 5, 9, 11, 14, 28, 32, 35, 36, 38), does not compel a different result. First, *Couch* involved a bookkeeper who was not even a CPA, not a firm of certified public accountants auditing the financial statements of a public company. Second, even more significantly, the information sought in *Couch*, unlike in this case, was the taxpayer's records which were in possession of the bookkeeper. Here the issue is the auditor's work product which contains its thoughts and impressions, not the transactional records created by the client. The distinction was made clear in *Donaldson v. United States*, 400 U.S. 517, 530 (1971):

> We turn, then, to Donaldson's particular situation. The material sought, as has been noted, consists only of Acme's routine business records in which the taxpayer has no proprietary interest of any kind, *which are not the work product of his* attorney or *accountant*, and which enjoy no established attorney-client or other privilege.

(emphasis added).

Finally, even if *Couch* controls the question of whether there can be an accountant-client privilege in the federal courts comparable to the attorney-client privilege, it is not germane to the issue before the Court. At stake here is an auditor's work product doctrine. This is as different from an accountant-client privilege as the attorney's work product doctrine is from the attorney-client privilege.

The Service makes much of Judge Newman's argument in dissent below that, because the auditor's work product doctrine as explicated by the panel majority would protect some communication, it was, in fact, a testimonial privilege already precluded by *Couch*. The argument reflects a serious misunderstanding of the majority opinion below. What the doctrine protects is the thought process of the auditor in much the same way that the attorney's work product doctrine protects the thought process of counsel. In either instance, information communicated orally is protected as an incident of protecting the thought process. As this Court said in *Hickman* v. *Taylor*, 329 U.S. 495, 511 (1947): "Proper preparation of a client's case demands that [the lawyer] assemble information," and characterized this process as occurring through interviews, among other means. *See generally* 329 U.S. at 515-19 (Jackson, J., concurring). Just as the presence of a communication in *Hickman* did not transform the attorney's work product doctrine into a testimonial privilege, so also here communication between auditor and client does not render the protection testimonial.

The Service further argues that, even if it were proper to create a privilege here, the privilege would only be available if there were

a valid "expectation of privacy." The Service claims none exists[15]

15. To the extent the Service suggests that no "expectation of privacy" exists with respect to communications between a client and its auditor, the statement is unfounded. Each state, the District of Columbia, and Puerto Rico have created Boards of Accountancy to regulate the practice of public accountancy pursuant to a grant of authority by the state legislature or, in the case of the District of Columbia, by Congress. These quasi-administrative agencies have adopted rules and regulations concerning the conduct of the practice of public accountancy, the violation of which can cause loss of one's license to practice or civil liability for breach of those rules—such as a breach of a confidentiality rule. *See, e.g., Family Health Foundation* v. *Peat, Marwick, Mitchell & Co.*, 556-004 (La. Civ. Dist. Ct. - Parish of Orleans, May 10, 1974) (if auditors had made available information to U.S. attorneys outside Federal Grand Jury prior to return date of subpoena, they would be liable to client for breach of Louisiana accountant/client privilege statute). *ConsoliData Services, Inc.* v. *Alexander Grant & Co.*, (79 Civ-02-590 Court of Common Pleas, Franklin County, Ohio), *appeal pending*. (Jury verdict against Alexander Grant & Co. in the amount of $1,300,000 for alleged breach of confidentiality rules of Ohio State Board of Accountancy.) *Client's Suit Against Alexander Grant Spotlight's 'the Accountant's Dilemma'*, Wall St. J., October 27, 1981 at 8. *See also Horne* v. *Patton*, 291 Ala. 701, 287 So. 2d 824 (1973) (physician can be civilly liable for breach of confidential physician/patient relationship); *Geisberger* v. *Willuhn*, 72 Ill. App. 3d 435, 390 N.E.2d 945 (1979) (breach of confidential relationship and breach of contract are coextensive). *Cf. Valley Bank of Nevada* v. *The Superior Court of San Joaquin County*, 15 Cal. 3d 652, 547 P.2d 977, 125 Cal. Rptr. 553 (1975) (en banc).

Each State Board of Accountancy has adopted a rule of confidentiality as to materials provided by a client to its CPA. *See, e.g.*, N.Y. EDUC. LAW § 6502 (MCKINNEY) and Rules Promulgated pursuant thereto at § 70.5(a)(7). N.Y. ADMIN. CODE tit. 8, § 70.5(a)(7). The respective ethics codes of professional conduct of the AIPCA and state CPA societies impose similar responsibilities. Similarly, as a matter of policy to reflect changing societal needs, the legislatures of 17 states and Puerto Rico have codified this expectation of privacy into a formal privilege. (Appendix A contains a listing of the confidentiality regulations for each state.) *Cf. Couch* v. *United States*, 409 U.S. 322, 350-51 (1973) (Marshall, J., dissenting) ("It would be relevant to a decision about the expectation of privacy that an accountant-client privilege existed under local law. . . . But I would think that, privilege or not, a disclosure to an accountant is rather close to a disclosure to an attorney.").

Arthur Young does not argue here (nor did it do so below) that there is a statutory or common law privilege which insulates its tax accrual papers for Amerada from the IRS. Rather, Arthur Young urges that, where an expectation of confidentiality exists, as reflected in state statutory privileges or requirements of confidentiality or where there are strong public interests which could be jeopardized, such as the full

because it could call for all materials underlying the tax return. (Pet. Br. at 6, 11-12.) This is a *non sequitur*. Because a client's communication of facts to an attorney is otherwise discoverable from the client does not mean that the client has no expectation of privacy as to the communication. At no time has Arthur Young ever suggested that the facts underlying "the tax returns and payments" are not discoverable by the Service. Rather, Arthur Young recognizes that these underlying facts are discoverable and has pointed out that the Service has, in fact, obtained such data here. *See* discussion *supra* at 5, 15 n. 9. It is axiomatic that the materials underlying the return are *not* the same as opinions (created after the returns have been filed) evaluating the financial reporting impact of tax positions previously taken on prior returns. *Cf.* FED. R. EVID. 407.

Finally, to the extent that the Government devotes much of its brief to distinguishing the accountant from the attorney and noting that only the attorney-client privilege was recognized at common law, we note that the accounting profession is barely one hundred years old; and its development is really a product of the past 50 years. This is precisely the situation contemplated by both Rule 501 and this Court's opinion in *Trammel* — the development of privilege based on modern reason and experience. Such experience dictates the need to carve out the limited privilege at issue here.

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financial reporting mandated by the Federal securities law, a much greater showing of need must be made before access can be obtained. Under these circumstances the creation of a qualified privilege (or doctrine) is a proper exercise of judicial discretion. This is particularly applicable where the information is sought from a third-party and the transactional documents which control the contested issues are available from the taxpayer.

III.

THE TAX ACCRUAL WORKPAPERS ARE NOT RELEVANT OR MATERIAL WITHIN THE MEANING OF SECTION 7602

As this Court noted in *United States* v. *LaSalle National Bank*, 437 U.S. 298, 316 n.18 (1978):

> Congress has bestowed upon the Service the authority to summon production for four purposes only: for "ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax . . . or collecting any such liability."

It is only the first of these four grants of authority that is applicable here—ascertaining the correctness of Amerada's tax return. Thus, the relevancy of the materials sought must be tested by whether they will assist in ascertaining the "correctness" of a tax return.

Relevancy should not be confused with convenience. There is little doubt that the tax accrual papers would be highly convenient for the Service. They would, in fact, provide the road map to all possible tax issues, as well as an intimate understanding of the taxpayer's intentions with respect to pending disputes with the Service. But convenience is neither a substitute for, nor the *sine qua non* of, relevancy.[16] In fact, in many instances, as here, there is no relationship between the two.

To the extent that the tax accrual workpapers contain facts, those facts are otherwise available from the taxpayer, in the public record, or in other audit workpapers which are otherwise available to the Service. This is indisputable. (JA 38). The bulk of the tax accrual workpapers, however, contain material which is not factually oriented, but is instead analytic, impressionistic, and

16. *See, e.g., United States* v. *Arthur Young & Co.*, 496 F. Supp. 1152, 1157 (S.D.N.Y. 1980), *aff'd in part and rev'd in part*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, U.S. , 103 S.Ct. 1180 (1983) (convenience is not the touchstone; access to audit plans and programs denied); *United States* v. *Davey*, 543 F.2d 996, 1000 (2d Cir. 1976); *United States* v. *Matras*, 487 F.2d 1271, 1275 (8th Cir. 1973).

speculative. Such material is not, and cannot be, relevant. Further, the fact that the independent auditors may have analyzed a tax return issue in a particular way long after the tax return was filed makes tax accrual workpapers inadmissible in evidence under any definition of relevancy. The tax accrual workpapers would not tend to prove the truth of the matter at issue or tend to show that the matter at issue is more probable or less probable of being true. FED. R. EVID. 401.[17]

THUS, IN *P.T. & L. Construction Co., Inc. v. Commissioner*, 63 T.C. 404 (1974), the Service opposed discovery of an IRS Special Agent's report and the Appellate Conferee's report on a disputed tax matter. The court denied access on the grounds that the material was irrelevant:

> What is relevant is the *factual information* which may either reveal evidence that will be admissible at the trial or lead to the discovery of such evidence. Mental impressions, legal analysis, conclusions, and recommendations are generally not relevant.

Id. at 414.

See also United States v. El Paso Co., 682 F.2d 530, 545-51 (5th Cir. 1982) (Garwood, J., dissenting) (only factual data is relevant), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

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17. In *United States v. Allison*, 474 F.2d 286, 289 (5th Cir. 1973), the court held:

> [R]elevancy describes the logical relationship between a proffered item of evidence and a proposition that is material or provable in a given case. *See* . . . C. McCormick, *supra*, § 152 ("the tendency of the evidence to establish a material proposition"); 1 F. Wharton, *supra*, § 148; 1 Wigmore, *supra*, § 12. According to Rule 401, Rules of Evidence . . . relevant evidence means "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Thus, evidence is relevant when it is persuasive or indicative that a fact in controversy did or did not exist because the conclusion in question may be logically inferred from that evidence. *Cf. Butler v. Watkins*, 80 U.S. (13 Wall.) 456, 20 L.Ed. 629 (1871).

Accord Williams v. Hoyt, 556 F.2d 1336, 1339 (5th Cir. 1977), *cert. den.*, 435 U.S. 946 (1978).

The court also denied production of those portions of the Special Agent's report which contained "a statement of the recommendation of the revenue agent, and the recommendations of the Special Agent and his deliberations that lead him to his recommendations. No new fact is recited in these portions of the report." *Id.* The court went on to reject discovery of the Appellate Conferee's report because it contained:

> summary of the facts already in the file, his analysis of the law as applied to those facts, and his recommendation on any settlement proposal discussed at the conference. The report does not contain any new *factual* information. . . . In our judgement the objectives of discovery do not require the production of this material. Its only value to petitioners lies in its statement of the legal theory adopted by the conferee."

Id. at 411-12.

Similarly, in *Esson v. Commissioner*, 34 Tax Ct. Mem. Dec. 586 (CCH) (1975), the tax court held that the petitioning taxpayer was entitled to discovery of all facts upon which the IRS valued shares of stock for gift tax purposes but denied access to judgments and opinions. The court stated:

> However, to the extent that by certain interrogatories, petitioners have sought to discover how respondent weighed the various elements of factual data in making his determinations as to value, *we think that petitioners are seeking discovery of an adverse party's mental impressions and analyses of a case, areas which are not generally open to discovery under our rules. P.T. & L. Construction Co.*, 63 T.C. at 414; note to Rule 70(b) Tax Court Rules of Practice and Procedure (60 T.C. 1098). *Cf. Hickman v. Taylor*, 329 U.S. 495 (1947). As to such interrogatories, . . . we hold that no further response from respondent is required.

Id. at 586-87 (emphasis added).

Ironically, the Service itself has conceded that opinions in the tax accrual file are not relevant. In IRS Information Notice 80-7, which announced the Manual change, 1 [Audit] INT. REV.

MAN. (CCH) § 4024, on tax accrual workpapers, the IRS stated: "The examiner's interests in the 'items' that make up the tax accrual does not include the independent accountant's or taxpayer's opinion of the value of issues or the likelihood of success in litigation . . ." Notwithstanding this concession, the Service is pursuing those opinions. (Pet. Br. at 25-26.)

The court's decision in *P.T. & L.* was a product of balancing "the interest of taxpayer discovery against government privacy . . . ." 63 T.C. at 411. Historically, the determination of relevancy has been a product of the balancing of interests. As one commentator has noted:

> A careful analysis of these cases reveals that the courts have applied the relevancy and convenience tests only after they had already decided the greater underlying interests involved. Arguably, any document that sheds light upon a tax return would be convenient to the IRS. Alternatively, any information that makes the Service's investigation more convenient would shed light upon the return because the very nature of the Service's inquiry is focused to this end. The two courts that have denied access on relevancy grounds nevertheless concluded that the papers were convenient. Thus, if these courts had applied the liberal "might have thrown light upon the return" test, the result might have been different.
>
> The above analysis lends credibility to the premise that the relevancy concept inherently involves a balancing process.[148]

148 *See* C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE § 77, at 159-60 (E. Cleary 2d ed. 1972):

> Reconciling interests in privacy and confidentiality with the needs of litigants is not readily achieved in terms of broad categories; it calls for the finer touch of the specific solution. A tool already at hand, though perhaps largely unrecognized, consists of recognizing standing on the part of the possessor of information to question the legitimacy of need for it in litigation, *i.e.*, to raise issues of relevancy in the broad sense . . . Relevancy

> itself, of course, contemplates a process of weighing, and inevitably the judge must be accorded a substantial measure of discretion.

Note, *Auditor-Client Work-Product Privilege With Respect To Tax Accrual File: The Arthur Young Case*, 27 ST. LOUIS U.L.J. 437, 453-54 (1983)(footnote omitted.)

Thus even when facts are sprinkled through the evaluative materials, the courts have found the material sought was not relevant, if the facts are otherwise available. *Esson v. Commissioner*, *supra*, and *P.T. & L. Construction Co., Inc. v. Commissioner*, *supra*. Specifically with respect to the tax accrual files, both courts which considered the issue in *United States v. Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), found the tax accrual workpapers were not relevant.

In *Union Carbide Corp. v. Travelers Indemnity Co.*, 61 F.R.D. 411 (W.D. Pa. 1973), a closely analogous case, an insurance company was asked in discovery what reserves it carried on the liability asserted in the case. "The answers sought involve[d] the internal opinions and conclusions of [the insurer]." *Id.* at 413. Noting that the 1970 amendments to the Federal Rules rendered opinions discoverable, the court nevertheless held:

> [T]he intent of the Rules is directed to opinions as to factual issues in controversy and do not render discoverable the internal opinions and conclusions [the insurer] has reached in valuating the reserves in issue. We note that Travelers has not cited and we have not discovered any authority for compelling the discovery of an insurance carrier's reserve against the liability asserted either in the principal case or in collateral claims. More importantly, we do not believe that the proper end of discovery—expedition of the litigation either by narrowing the areas of controversy or by avoiding unnecessary testimony or by providing a lead to evidence—will be served by allowing discovery of the reserves in question.

Id. (citations omitted).

Not only has no general relevancy been shown here for the tax accrual papers, but also when the record is examined, it is clear that the tax accrual papers can have no relevance whatsoever to the subject matter of the investigation — at least as defined by the affidavits in support of summons enforcement below. The affidavits stated only that the summoned records were needed "to ascertain the correctness of the 1972, 1973 and 1974 returns" except for one matter which was specifically identified. As to this one matter Arthur Young submitted the affidavit of Bruce Greenwald, tax partner on the Amerada audit, who stated that he reviewed "the tax accrual workpapers prepared by Arthur Young in connection with its audits of Amerada for the years 1972, 1973 and 1974 [and] there is no information whatever" therein with respect to that matter. (JA 38 ¶¶2, 3). Under these facts, especially when applying the balancing test, it is clear that the tax accrual workpapers are neither relevant nor material.

CONCLUSION

IRS access to the thought processes and evaluations of the independent auditors runs afoul of inherent fundamental fairness, particularly where the Service is in an adversarial posture with the taxpayer as to matters contained therein. Such access would seriously damage important professional relationships and other critically important Congressionally mandated policies. Absent a compelling specific need, which has not been shown here, the Service should not be allowed access to these documents. Accordingly, the opinion of the Court of Appeals should be affirmed.

DATED: September 9, 1983
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APPENDIX A

State Board of Accountancy Confidentiality Regulations

State	Enabling Statute	Confidentiality Regulations*
Alabama	Ala. Code § 34-1-3(n) (1975)	Reg. 5, 4(1) CCH ALR ¶1254
Alaska	Alaska Stat. § 08-04-080	12 AAC 04.020 Authority: AS 08.04.070(b); AS 080.04.080 CCH ALR ¶ 1604
Arizona	Ariz. Rev. Stat. Ann. § 703 (A)(1) (Supp. 1981-82)	Rule C(1) CCH ALR ¶ 2403
Arkansas	Ark. Stat. Ann. § 71-612(d) (1979)	Arkansas has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 3271
California	Cal. Bus. & Prof. Code § 5018 (West Supp. 1982)	Rule 54 CCH ALR ¶ 4402
Colorado	Colo. Rev. Stat. § 12-2-104-(2)(c) (1973)	Colorado has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 5401
Connecticut	Conn. Gen. Stat. Ann. § 20-280 (Supp. 1982)	Sec. 20-280-15C CCH ALR ¶ 6401
Delaware	Del. Code Ann. tit. 24, § 109(9) (1974)	Delaware has adopted the code of professional ethics of the American Institute of Certified Public Accountants CCH ALR ¶ 7301
Dist. of Columbia	D.C. Code Ann. § 2-103(i)(2)	CH. II. Sec. 202 CCH ALR ¶ 8153
Florida	Fla. Stat. Ann. § 473.304 (1981)	Rule 21A-23.01 CCH ALR ¶ 9238

* The confidentiality rule promulgated by each Board of Accountancy is listed. Each rule can be found in CCH Accountancy Law Reporter (hereafter cited "CCH ALR").

State	Enabling Statute	Confidentiality Regulations*
Georgia	Ga. Code. Ann. § 43-3-5(a)(2) (Supp. 1982)	Georgia has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 10,401
Hawaii	Hawaii Rev. Stat. § 466-4(f)(2) (1976)	Hawaii has adopted the code of professional conduct of the National Association of State Boards of Accountancy except subrule (c), Rule 404 and entire Rule 405 CCH ALR ¶ 10,801
Idaho	Idaho Code § 54-204-A.(1)	Rule 301 CCH ALR ¶ 11,405
Illinois	Ill. Rev. Stat. Ch. 111 § 5532 (1969)	Rule 301 CCH ALR ¶ 12,406
Indiana	Ind. Code Ann. § 25-2-1-3(L) (Burns 1982)	Indiana has adopted the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 13,301
Iowa	Iowa Code Ann. § 116.3-4(a-i) (West Supp. 1982-1983)	Rule 10-11.6(116)(i) CCH ALR ¶ 14,481
Kansas	Kan. Stat. Ann. § 1-203-(C)(1) (1982)	Kansas has adopted with some changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 15,351
Kentucky	Ky. Rev. Stat. § 325.240 (1977)	Rule 301 CCH ALR ¶ 16,405
Louisiana	La. Rev. Stat. Ann. § 37:75-B(2) (West Supp. 1982)	Louisiana has adopted with changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 17,301
Maine	Me. Rev. Stat. Ann. tit. 32, § 3972 (Supp. 1982)	Maine has adopted with some changes the code of professional conduct of the National Assocation of State Boards of Accountancy CCH ALR ¶ 18,401

State	Enabling Statute	Confidentiality Regulations*
Maryland	Md. Ann. Code of 1957 § 75A(1)(d) (1957)	Maryland has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 19,301
Massachusetts	Mass. Gen. Laws Ann. ch. 112 § 87-C(a) (1971)	Sec. 3.03(1) CCH ALR ¶ 23,504
Michigan	Mich. Stat. Ann. § 339.308 (West Supp. 1982)	Sec. 338.2120 (Confidential information) CCH ALR ¶ 24,514
Minnesota	Minn. Stat. Ann § 326.18 (1981)	Minnesota has adopted the restatement of the code of professional ethics of the American Institute of Certified Public Accountants with minor modifications CCH ALR ¶ 25,721
Mississippi	Miss. Code Ann. § 73-33-5 (Supp. 1982)	Rule 301 CCH ALR ¶ 26,615
Missouri	Mo. Ann. Stat. § 326.160.1 (Vernon Supp. 1983)	Missouri has adopted the code of professional conduct of the National Association of State Boards of Accountancy with minor changes CCH ALR ¶ 27,501
Montana	Mont. Code Ann. § 37-50 (1981)	Rule 301 CCH ALR ¶ 28,701
Nebraska	Neb. Rev. Stat. § 1-112 (1977)	Rule 5 CCH ALR ¶ 29,505
Nevada	Nev. Rev. Stat. § 628.160 (1981)	Rule 301 CCH ALR ¶ 30,531
New Hampshire	N.H. Rev. Stat. Ann. § 309-A:2-a-I(f) (Supp. 1981)	Part Ac 505 Rule 01 CCH ALR ¶ 31,701
New Jersey	N.J. Stat. Ann. § 45:2B-6 (West 1978)	Rule 7(a) Sec. 13:29-3.4 CCH ALR ¶ 32,507
New Mexico	N.M. Stat. Ann. § 61-28-6 (Supp. 1978)	New Mexico has adopted the code of professional conduct of the National Association of State Boards of Accountancy with minor changes CCH ALR ¶ 33,501

State	Enabling Statute	Confidentiality Regulations*
New York	N.Y. Educ. Law § 7403 (McKinney's 1977)	Part 29 Sec. 70.5 CCH ALR ¶ 34,101 & ¶ 34,102
North Carolina	N.C. Gen. Stat. § 93-12(8b) (Supp. 1981)	Sec. 0204 CCH ALR ¶ 35,714
North Dakota	N.D. Cent. Code § 43-02. 1-02.-6 (1977)	North Dakota has adopted with changes the restatement of the code of professional ethics of the American Institute of Certified Public Accountants See also Sec. ¶ 84-216
Ohio	Rev. Code Ann. § 4701.03 (Page 1977)	Ohio has adopted the rules of conduct, restatement of the code of professional ethics of the American Institute of Certified Public Accountants, with some changes CCH ALR ¶ 37,501
Oklahoma	Okla. Stat. Ann tit. 59, § 15.5 (West 1971)	Art. 301 CCH ALR ¶ 38,171
Oregon	Or. Rev. Stat. § 673.445 (1981)	Rule 301 CCH ALR ¶ 39,701
Pennsylvania	63 PA. Const. Stat. Ann. § 9.3(10) (Purdon Supp.1982-83)	Sec. 11.1 CCH ALR ¶ 40,025
Puerto Rico	P.R. Laws Ann. tit. 20, § 773 (1974)	Sec. 773-204
Rhode Island	R.I. Gen. Laws § 5-3-10 (197_)	Art. 3, Sec.3.1 CCH ALR ¶ 42,321
South Carolina	S.C. Code Ann. § 40-1-140 (Law. Coop. 1976)	South Carolina has conformed to the restatement of the code of professional ethics of the American Institute of Certified Public Accountants with minor changes CCH ALR ¶ 43,501
South Dakota	S.D. Codified Laws Ann. § 36-20-1 (1977)	S.D. Admin. Code - Ch. 20:37:04:14 CCH ALR ¶ 44,514

State	Enabling Statute	Confidentiality Regulations*
Tennessee	Tenn. Code Ann. § 62-1-111 (1982)	Tennessee has adopted the restatement of the code of professional ethics of the American Institute of Certified Public Accountants without substantial changes CCH ALR ¶ 45,612 (rule 12 confidential client information deleted; but Tennessee has a privilege statute: § 62-1-116.
Texas	Tex. Rev. Civil Stat Ann. art. 41a § 4(A) (Vernon Supp. 1982-1983)	Ch. 501 Sec. 501.31 CCH ALR ¶ 46,631
Utah	Utah Code Ann. § 58-1-7 (Supp. 1981)	Utah has adopted the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 47,501
Vermont	Vt. Stat. Ann. tit. 26, § 54 (Supp. 1983)	Vermont has adopted the code of professional conduct of the National Association of State Boards of Accountancy, with certain modifications CCH ALR ¶ 48,501
Virginia	Va. Code § 54-84 (1982)	Sec. 16.01 CCH ALR ¶ 50,347
Washington	Wash. Rev. Code Ann. § 18.04.070 (1978)	Washington Admin. Code 4-16-370 Rule 301 CCH ALR ¶ 51,501
West Virginia	W.V. Code § 30-9-1 (1980)	Rule 21.03 CCH ALR ¶ 52,405
Wisconsin	Wisc. Stat. § 442.01(2) (Supp. 1982-1983)	Wisc. Admin. Code, Accountancy Reg's Subchapter III, Accy 1.301 CCH ALR ¶ 53,421
Wyoming	Wyo. Stat. § 33-3-108(a)(ii) (1977)	Rule 301 CCH ALR ¶ 54,401